

THE CHARITABLE TRUST (THE FOUNDATION) AS AN INSTRUMENT OF ESTATE PLANNING

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The term "foundation" is used in this article to cover the philanthropic mechanism created by incorporation as well as that created by trust. The incorporated form grows increasingly more popular for reasons of convenience in management, and because some of the uses of foundations to which I shall refer are more difficult to employ in trust form.

A dictionary definition of "foundation" might run something like this: "A fund obtained either from donation or legacy for the permanent maintenance of an institution, eleemosynary or other, or for some particular object . . . or the institution so supported." Such a definition includes institutions such as churches, colleges and hospitals, and is broader than the limited sense in which I shall use the term. I can best describe my use by illustration: "foundations", regardless of size, of a class generally similar to the Ford Foundation, the Carnegie Corporation of New York, the Rockefeller Foundation and the Twentieth Century Fund. I shall mean to include not only foundations which are strictly distributive but also those which are applied, wholly or in part, to operating purposes like research.

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The rapidly increasing birth-rate of foundations does not, in itself, indicate an increase in generous intent. The foundation has become an extremely useful vehicle in estate planning, and often a profitable one. This is not, however, an unhappy development. If society can gain through the effort of the citizen to benefit himself, there is no ground for complaint. True, foundations sometimes devote themselves to idiosyncratic ends, but society should suffer this, I think, in order not to dry up springs of charity.

There have been substantial abuses of the tax-exempt foundation vehicle. Congressional investigation has disclosed many very serious derelictions on the part of some foundations which have permitted themselves to operate with political intent or bias.¹ It is the hope of those who are concerned over this problem that reform will come from within the foundations themselves, to avoid the necessity of any further restrictions which might discourage their use.

There also have been many "business" abuses of the foundation form—attempts to take advantage of the vehicle for improper personal gain. Most avenues of abuse have now been closed by provisions of the

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¹ See Report of the "Reece Committee," House of Representatives Report No. 2681, 83rd. Congress, 2nd. Session.

Internal Revenue Code, which withhold the applicable tax exemptions and deductions if the foundation is used in prohibited ways. I shall not go into these proscribed activities, but shall confine myself to some of the constructive, proper uses to which foundations can be put in the course of life-and-estate planning.

In most of these instances, an existing institution might be used just as well as a specially created foundation. There are cases, however, in which certain special controls or functions may be exercised by the charitable donee; here the donor may well wish to pour his money into a mechanism which, in effect, he can himself control through the appointment of managing trustees who are likely to do his wishes. Moreover, the donor may have more than one use in mind for his charitable donation, or more than one connected planning objective; he may wish to have a single mechanism available to several ends. Nor should we neglect the legitimate egotistical satisfaction which the donor may find in giving the foundation his name. Finally, a foundation controlled through an amenable board of directors can be integrated into a general estate plan, serving the double purpose of a distributive mechanism during life and an instrument of direct estate planning.

THE FOUNDATION FOR CHARITABLE DISTRIBUTION DURING LIFE

One of charitable inclination who wishes to take fullest advantage of his permissible income tax deductions, may have difficulty in deciding promptly upon the objects of his bounty. Time need not press him if he has a foundation. He can, within the year, pay over his full allowed 20% to the foundation, and postpone the decision on detailed distribution until he gets around to it. He still has left, of course, an additional 10% for direct donation to the limited list of institutions, gifts to which can raise his deductions to an aggregate of 30% of his taxable income.

It may be that the donor is not satisfied to make a comparatively small donation annually to some institution but may prefer to accumulate funds with which to make a grander gift later. This he can arrange through a foundation. Income may not be accumulated unreasonably in a foundation. However, the donations to it are not income but principal in its hands. Thus, they may be accumulated. Even the income may be accumulated if Internal Revenue can be satisfied that it is not "unreasonable"—perhaps in the case of a definitive and irrevocable dedication to a proper purpose, such as the erection of a building.

Such a foundation can also act as a buffer and a shield between the donor and those who so frequently importune him with solicitation. He can shift all requests to his foundation.

THE CHARITABLE TERM TRUST

The graduated income tax system, as it has been developed in the past decades, falls far short of one of the objectives of some of its more radical supporters; it does not tend to level off the rich. It is the precious

middle class which it attacks most severely. The so-called laboring class does not worry about income tax. It is concerned with "take-home pay" and leaves to the employer the burden of paying the tax. As for the rich, there are many ways in which they can avoid too heavy an income tax impact. Indeed, our income tax system sometimes gives them an opportunity to make more money. Here is an example, in which a foundation may be employed.

Let us deal with a Mr. Smith who is in an 80% top income tax bracket. We shall have him create an irrevocable trust with a principal of \$50,000 in government bonds paying $2\frac{1}{2}\%$. The income is to go to an existing charity or to his foundation for a period of ten years. At the end of that period we could turn the principal back to Mr. Smith, but let us plan further and pay the remainder to his wife. The principal thus never leaves the family. Indeed, it results in a capital transfer to the wife at minimum cost—gift tax on the value of the remainder. The remainder, payable after ten years, is valued roughly at \$35,000. As half this gift would be exempt under marital deduction, the taxable gift would be only \$17,500, a sum tax-exempt because within Mr. Smith's \$30,000 life-time exemption. If he has exhausted his exemption, the gift would still be far cheaper than a transfer by will.

Not only has Mr. Smith made a cheap transfer to his wife, but he has lost nothing by way of income. On the contrary, he has made an actual cash profit. Had he kept the entire income for ten years, he would have received an aggregate of \$12,500. Taxed at 80%, however, he would have been left with only \$2,500 of useable income. In contrast to this, having made a ten year gift of income to his foundation (or any other charity, for that matter), he is entitled to an income deduction in the year of creation of the trust for the full present value of the donation. This value is \$14,550. Assuming this to be within his 20% available income tax deduction, it is worth 80% in cash to him, or \$11,640. Thus he has sacrificed ten years income worth \$2,500 and gained \$11,640—a net profit of \$9,140.²

THE CHARITABLE REMAINDER

Suppose Mr. Smith's one major objective in his estate plan is to make sure that his wife is taken care of as well as possible; that he has no issue and no deep concern for other possible beneficiaries. If he leaves all his estate to his wife, half will be tax-free under marital deduction but the other half will be taxed, and the fund from which his wife might expect income will be correspondingly reduced. On the other hand, if he qualifies half his estate for marital deduction and creates a trust of the remaining half, of which his wife will receive the income,

² See my article *Gifts to Charity Can Actually Put Money In Your Pocket If You're Rich Enough*, *The Journal of Taxation*, April, 1956, p. 211, for a full description of this type of plan and for tables showing the net profit at various rates of security income and various top income tax brackets.

the principal finally passing to a charity at his death, all that would be subject to estate tax would be the value of the life interest of the wife in half the estate. By this means the fund from which the widow would receive income would be materially increased. By this means, also, Mr. Smith's foundation, created in part, perhaps, to attach his beloved wife's name to a charity, would be benefited substantially.

The charitable remainder can be employed in an *inter vivos* trust as well as one testamentary. If creating a trust for another's support involves gift tax, the tax can be cut down materially by passing the remainder to charity—i.e. a foundation, the value of the remainder being excluded in computing the taxable gift.

Indeed, if Mr. Smith intends to pass a certain amount of property to his foundation at his death, he might well consider creating an irrevocable trust for himself, reserving the life interest and giving the remainder at his death to the foundation. In the year of creating this trust, the value of the remainder would be available to him as an income tax deduction. If the sum exceeds his permissible charitable deduction for the year, he can take two or more annual bites at the transaction, throwing into the trust only so much each year as will give him the maximum use of his charitable deduction.

A similar result can be obtained by donations of physical property, reserving the life use. This could be real property or tangible personal property such as paintings. The value of the property, less the value of the life use, would constitute a charitable donation, available for income tax deduction.

A TRANSFER IN EXCHANGE FOR AN ANNUITY

Other plans might be submitted to Mr. Smith if he wishes to make a donation to his foundation but to reserve some interest for himself. One is to transfer property in exchange for an annuity for life or for someone else's life. Many institutions have solicited donations on this plan, notably Pomona College in California. Such institutions offer lower annuity benefits than would insurance companies. On the other hand, there is, in these plans, always a residual gift to the charity, and the value of this is available for income tax deduction. Moreover, the purchaser of such an annuity can buy it with securities which have had an increase in value and receive credit for the full market price. In contrast, if he bought an annuity from an insurance company, he would have to sell securities, presumably, and pay a capital gain tax.

How much gift is involved in such an annuity transaction? The difference between the total sum donated and the cost of a comparable policy purchased through an insurance company would constitute a charitable gift.

There seems no reason why a foundation cannot contract for an annuity of the sort described, in the same way as colleges and other institutions do now. There is the hazard, of course, that, while a college,

let us say, would maintain a permanent endowment fund as protection against its annuity liabilities, a foundation might disburse its capital and leave the annuitant without protection.

Institutions offer another type of income plan, under which, instead of fixed annuity payments, the donee receives income based upon the actual rate earned by the institution on its invested funds. In contrast to the annuity, however, the income from this type of contract is wholly taxable with income tax.

DONATIONS OF LIFE INSURANCE

This form of donation to a foundation may be extremely valuable in many cases. The most common method is for the donor to take out a policy on his own life, making the foundation his irrevocable beneficiary. The premiums paid, then, are deductible for income tax purposes and the principal is excluded from his estate tax. The policy might even be assigned to the charity, to give it the added protection that it could always pay the premiums itself, in the event the donor lapsed in his enthusiasm.

This form of transaction has sometimes been complicated by superimposing on it a contract with the charity to which the policy is assigned, under which it agrees to give a stipulated annuity or life income benefit to named persons after the insured's death.

TO SOLVE THE ESTATE SHRINKAGE PROBLEM

In this era of high personal income taxes it is not surprising that many men of wealth die leaving unliquid estates. Except for the factor of capital gains, the corporation has become almost the sole vehicle for the building of substantial wealth. In spite of rules restricting the accumulation of profits, the corporation can amass wealth in a manner unavailable to the individual. It is typical of the age, then, that in many estates large wealth is represented almost entirely by holdings in one or more closely-held corporations. The larger the estate, the heavier the percentage of shrinkage due to death taxes—and there are other elements of shrinkage also: debts and administration expense. In addition, some cash legacies usually must be provided for. Where is all the necessary cash coming from? The Commissioner of Internal Revenue cannot be paid in kind.

There are many ways of attacking the shrinkage problem. But in some very large estates, most of these methods may be impractical. In such instances, the use of a foundation has become increasingly popular. To illustrate the problem involved and the foundation approach to a solution, let us take the extreme, fictitious case of Mr. Lancaster who has built up a huge enterprise during his life.

In analyzing Mr. Lancaster's estate we conclude that his ownership of the Lancaster Corporation will be appraised at his death at \$100,000,000. We find that the balance of his estate will aggregate

only an additional \$2,000,000. And we know that he wishes to leave his wife and children a total of at least \$1,000,000 in cash or liquid securities. His taxable estate would be \$102,000,000, less administration expense, which we can here estimate at 5% or \$5,100,000, or a net taxable of \$96,900,000. His Federal death taxes alone on this sum, using full marital deduction, would be about \$35,700,000; but he would have to anticipate that the tax impact upon his wife's death would be repeated in close to the same amount as his own death tax bill. If he used no marital deduction, his Federal tax would be \$73,000,000. Obviously, there is no easy solution to the liquidation problem in this estate except through a disposition of securities of the Lancaster Corporation.

Mr. Lancaster or his estate could syndicate a block of his stock through bankers or brokers, but difficult problems would arise. As the sole owner of the Lancaster Corporation stock, it would be appraised at his death at the full market value of the company as a going concern. Yet the individual shares of stock, widely distributed among the public, would have far less market value per share. The entire company might be worth its full book value plus an item for good-will, reflecting profit propensity. If Mr. Lancaster's estate retained a controlling interest, this might be appraised at close to the value, per share, of sole ownership. But the individual shares of many mighty corporations sell in the open market for considerably less than their book value.

Mr. Lancaster might, therefore, have to sell from ten to fifty per cent more of his stock than the figures indicate, in order to raise his liquidity deficit. There is this further complication, that a sale during his life would involve capital gain tax, possibly raising to a truly impossible figure the amount of stock he would have to sell in order to meet his liquidity deficit.

What kind of stock should be sold? Through various types of recapitalization, Mr. Lancaster might produce a stock which gave the public an interest in inequity growth, plus some preferred security, and also a participation in voting control. He might possibly be able to sell preferred stock alone, keeping equity growth and voting power in his family's hands. But, no matter what solution to the difficult problem of stock-type selection were arrived at, Mr. Lancaster might face the necessity of either disposing of more than three-fourths of the value of the business at his death or else planning for a second liquidation on the subsequent death of his wife.

We might, then, suggest that he arrange to pass enough of the Lancaster stock to the Lancaster Foundation to reduce his tax bill to such reasonable limits as might permit an easy solution of the liquidity problem by collateral methods. We might advise that preferred stock be used for this purpose, so that voting power, equity growth and even the reflection of increased dollar value through inflation come to his family.

I have used an extremely rich Mr. Lancaster to emphasize the seriousness of the liquidation problem. It may be just as serious, however, in the case of a far more modest business man. He may find it impossible to market a sufficient section of his stock-ownership in order to meet his expected estate cash deficit. The Lancaster Corporation is big enough so that a public marketing could probably be relied upon. But the owner of a comparatively small, though substantial, business might have to sell control in order partially to liquidate during his life. This sad factor is likely to persist after his death—that is, whereas the estate of the owner of a great enterprise may, in some instances, be able to solve the liquidity problem by a sale of part-ownership, the estate of the owner of a smaller business may have to sacrifice control or even sell the whole business.

Thus, the foundation solution may often be very valuable for the proprietor of an enterprise far more modest than Mr. Lancaster's.

LIQUIDATION DURING LIFE

Our fictitious Mr. Lancaster could arrange by will for a massive donation to his foundation of the kind I have discussed. On the other hand, he might do better by starting a program of annual gifts during his life-time. We may assume he has an annual net taxable income of some \$4,000,000. This would give him a maximum deduction of \$800,000 per year for gifts to a foundation. If he donated this sum annually to his foundation in the form of preferred stock, he would be gradually liquidating at a discount of less than 10%, for the annual donation would save more than 90% in income tax.

Quite aside from tending to help solve the problem of estate liquidity, this method of annual liquidation at a small discount can be used to unfreeze the family capital during life. Indeed, the proceeds might be used to effect some partial diversification of the family investment portfolio, shifting some of the eggs to other investment baskets.

If Mr. Lancaster has this motive of liquidating partly for the purpose of diversifying his investments, donations to his foundation seem to be the answer. Let us assume that his stock is worth \$100 a share but has a cost base of only \$10. If he holds on until death, then, of course, the intrinsic capital gain is never taxed as such. But suppose he wants to cash in some shares. If he sells them, he pays a capital gain tax of \$22.50 per share and pockets \$77.50 per share. On the other hand, if he gives them to his foundation, the gift is deductible on his income tax return up to his deduction limit and is worth the equivalent of 90%, or \$90 per share in cash to him. Thus he liquidates at a discount of 10%, whereas a sale would have forced a discount of 22½%. In addition to this advantage, of course, he has made \$100 per share available for charitable purposes.

CONTROL THROUGH A FOUNDATION

Many great corporations have started as the instrument of a single person. Upon his death, his stock has passed to a succeeding generation,

control still being left in a few hands. Upon proprietorship passing to the third generation, however, maintaining control in some unified fashion became more difficult. Along about the next generation or the one following, either the stock was listed and distributed among the general public or else the family had grown so large and the relationships of its individual members in part so distant that it might be held to have become publicly owned. It is extremely difficult to preserve succession of management in a family.

A foundation can be used as an instrument of permanent control. Generally, it suits the purposes of the founder better to donate preferred stock to his foundation, in order that the family may have equity benefit. Where, however, his chief interest is in preserving control in one group, he may prefer to give common stock to his foundation. Indeed, he can sometimes combine objectives. He can, for example, give to the foundation a form of preferred stock which bears voting control and leave a non-controlling equity stock to his family.

By carefully selecting his foundation trustees and assuring himself, as best he can, that this self-perpetuating group will follow his own inclinations, he can come closest to perpetuating management in a contained group.

There is hardly any limit to the ingenuity which may be used in designing plans around a foundation vehicle. In one instance, I have proposed donating voting common stock to a foundation, preferred stock to the wife and a second class of common stock, of what might be called a revolving type, to the corporate executives. The revolving stock would be re-purchased by the corporation on death or retirement and then re-issued to successor executives at its then book value—the purpose being to enable the executives to cash in on equity growth.

CORPORATE DONATIONS AND "FRINGE BENEFITS"

Let us go back to the fictitious Mr. Lancaster whose company is so successful that it has an acute problem with regard to the unreasonable accumulation of surplus. The basic difficulty is, of course, that dividends are of small use to Mr. Lancaster, taxed at the top of the income tax scale. Whatever other solutions there may be to this frequently met problem, we might suggest to Mr. Lancaster that his corporation could ameliorate it in small part by taking advantage of the charitable deduction available to the corporation itself up to 5% of its taxable income. It could have its own foundation or, in certain circumstances, could use his own as the recipient.

There could be distinct value in corporate donations to a foundation which devoted itself to research in areas which might redound to the benefit of the enterprise; or to the training of technicians some of whom, it might be hoped, would join the corporation's staff; or to the support or development of various types of civic facilities from which the working force might benefit.

Moreover, a foundation must be managed. It must employ an adequate staff, measured by its size and activity. It can thus be used, in a small way, for the employment of some who have reached arbitrary retirement age in the corporation itself, or such as, by reason of some handicap, are unable to continue in their former work.

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These are but some of the ways in which the foundation vehicle can be turned to an estate planning use or to one connected with what might be called "life planning." Society gains through the increased use of the mechanism, which tends to induce persons of wealth to greater charity than if they did not have it available for legitimate personal use. It would be a sad day if private charity materially declines and *der Staat* had to pick up the unpaid bills.